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RUEATRS/DEPT OF TREASURY WASHINGTON DC
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RUEHKO/AMEMBASSY TOKYO 2846
RUEHBJ/AMEMBASSY BEIJING 5730
RUEHBY/AMEMBASSY CANBERRA 3403
RUEHUL/AMEMBASSY SEOUL 5229
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UNCLAS SECTION 01 OF 04 JAKARTA 002247

SIPDIS
SENSITIVE

DEPT FOR EAP/MTS, EAP/EP AND EEB/IFD/OMA
TREASURY FOR IA/MALACHY NUGENT AND TRINA RAND
COMMERCE FOR 4430/KELLY
DEPT PASS FEDERAL RESERVE SAN FRANCISCO FOR CURRAN
DEPARTMENT PASS EXIM BANK
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
USDA/FAS/OA YOST, MILLER, JACKSON
USDA/FAS/OCRA CRIKER, HIGGISTON, RADLER
USDA/FAS/OGA CHAUDRY, DWYER
DEPT PASS USTR WEISEL, EHLERS

E.O. 12598: N/A

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SUBJECT: FINANCIAL CRISIS IMPACT ON AVERAGE INDONESIAN RISING

REF: A) Jakarta 2206 B) Jakarta 2207 C) Jakarta 2104 D) Jakarta 2157

1. (SBU) Summary. To date the global financial crisis has affected primarily Indonesia's wealthy population, as middle and low income Indonesian have few or no stock or bond investments and the Indonesian banking sector has remained stable. The concurrent reduction in food prices and increase in government anti-poverty programs have also eased pressure on middle and low-income families in recent months. Yet analysts are predicting a sharp slowdown in growth, tighter credit conditions, rising unemployment, and pressure on wages through early 2009, increasing the likelihood that the effects of the financial crisis will spread to average Indonesian households.

2. (SBU) Turmoil in global financial markets has reduced the government of Indonesia's (GOI) ability to increase fiscal spending and ease monetary policy to blunt the impact of slower growth. Corporate and consumer credit quality is also set to decline, limiting the local banks' appetite to extend significant new loans. As the impact on middle and low-income Indonesians intensifies, confidence in the government may begin to wane. End summary.

Lower Food and Fuel Prices Boost Purchasing Power

3. (SBU) To date the global financial crisis has largely affected Indonesia's wealthy population, as middle and low-income Indonesian have few or no stock or bond investments. The concurrent slowdown in overall and food price inflation have eased pressure on middle and low-income families. Overall food prices fell 0.12% between October and November 2008 and the price of rice, which comprises as much as one-third of the total household spending in Indonesia, is down almost 7% from its 2008 peak (ref A). The government's recent reduction in the price of subsidized gasoline will also help offset transportation costs for Indonesian families. [Note: Although poor and middle-income families receive some benefit from lower gasoline prices, the bulk of the benefit accrues to wealthy, automobile owning Indonesians. End note.] In addition, the government's direct

cash transfer program and subsidized rice scheme have successfully boosted poor households' purchasing power this year.

14. (SBU) These benign trends helped increase consumer confidence and reverse some anti-government sentiment that had built up earlier in the year. Danareksa's Consumer Confidence Index rose for the fifth straight month in November, and Roy Morgan's consumer confidence barometer jumped 5.6 points between the second and third quarters this year. The gains in consumer confidence were attributed in large part to improved confidence among households earning less than IDR 500,000 per month (\$45.50). Danareksa's Confidence in Government Index also rose in November increasing 2.2% over the previous month, reflecting respondents' view that overall economic conditions had improved. Despite improved consumer confidence, the number of respondents that stated job scarcity was a major problem rose from 23.3% in October to 24.7% in November.

Growth Set to Slow Significantly

15. (SBU) While lower price levels have supported improved standards of living for many low-income households, a slowdown in the real sector resulting from the prolonged global financial crisis will likely undermine these trends. Analysts have significantly reduced their growth forecasts for Indonesia in 2009, in some cases from 6.0% to less than 4.0%, as exports and investment show significant signs of weakening. The sharp slowdown in overall world demand, as well as the sharp decline in the prices of many of Indonesia's primary commodity exports will continue to put downward pressure on the value and volume of exports in the coming months. Export growth slowed significantly in October (ref A) and anecdotal information from the business community suggests this trend will intensify in

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November and December. The sharp drop in commodity prices has also delayed payments to Indonesian commodity exporters, as buyers seek to renegotiate prices and bankers seize shipments that producers put up as collateral for loans, according to recent press reports.

16. (SBU) Limited access to financing also threatens to undercut export and investment growth over the medium term. The Indonesian corporate sector is significantly healthier now than in the years leading up to the 1997-98 financial crises, with debt-to-asset ratios of companies listed on the stock exchange declining 30 percentage points between 2000 and 2007, according to the IMF. However, even healthy firms are having difficulty accessing short-term trade finance due to a reduction in USD liquidity in the domestic banking system and rising risk aversion among foreign banking organizations, according to bankers at ING Jakarta. Bank Indonesia (BI) has announced plans to guarantee trade finance extended by banks with high credit ratings, but the effectiveness of the new program, initiated on December 5, remains unclear. The price of USD credit has more than doubled since June, according to the ING bankers, making loans cost prohibitive for all but the strongest Indonesian firms. According to bankers from UBS Jakarta, several prominent Indonesian firms with strong balance sheets have approached them to provide funds to refinance maturing USD debt in excess of \$100 million, raising concerns of large refinancing requirements in the corporate sector that have not been met by local or foreign banks. A growing number of local firms have cancelled all expansion plans in the near term in an effort to preserve cash, further diminishing the outlook for investment, according to ING.

Job Losses Begin to Mount

17. (SBU) Formal unemployment is set to rise significantly in Indonesia as economic activity slows, tempering the outlook for robust domestic demand growth. In particular, reduced global demand is likely to adversely impact Indonesia's labor-intensive export industries, such as garments, footwear, and electronics. Unemployment rates have already begun to rise, with over 60,000 workers in the formal sector either terminated or laid off this year. Analysts expect these trends to intensify during the first half of 2009, with as many as 1,000,000 people in danger of losing jobs (ref B). Rising job losses among middle class workers in the formal sector may flood the informal sector, as middle class

families shed household staff. While the informal sector can absorb many of the workers, the rise in the number of individuals seeking work will drive down already low wages in the sector.

¶18. (SBU) Anton Gunawan of Bank Danamon noted in a recent presentation that layoffs and wage reductions in the commodities sector outside Java have already lowered consumption levels in those regions. Many small palm oil plantation holders who enjoyed windfall profits this spring when palm oil prices reached their peak are now drastically readjusting their spending patterns, according to a recent World Bank survey. In line with these trends, car sales in Indonesia dropped to over 47,000 units in November from that of 54,000 units in the previous month, according to the Indonesian Automotive Industry Association. ING representatives in Jakarta warned of significant asset quality and liquidity problems in the consumer finance sector as job losses increase. These weaknesses may result in a sharp contraction in the availability of consumer credit and the failure of a number of subprime consumer credit firms, further depressing consumption patterns in 2009.

Financial Market Turmoil Limits GOI Ability to Respond

¶19. (SBU) Although the GOI and BI have been proactive in addressing the global financial crisis to date (ref C), higher funding costs and ongoing pressure on the currency limit the GOI's ability to blunt the impact of the global financial crisis on the real sector. In terms of fiscal policy, the yield on 10-year IDR denominated

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government bonds eased recently to roughly 12.0%, but had risen to over 20.0% as recently as late October as global risk aversion to emerging market debt intensified. The GOI has made significant efforts to secure funding from multilateral organizations (ref C), reducing the need to secure financing from the private sector to maintain spending levels. The reduction in oil prices has also reduced the size of the government's subsidy bill, creating additional space for spending. The GOI has stated plans to increase pro-poor and infrastructure spending in 2009, but few observers expect these initiatives to yield significant new jobs. A new large-scale spending program capable of creating long-term job growth will require private sector funding that is increasingly difficult to secure in a climate of rising risk aversion. In addition, the potential for corruption in large-scale infrastructure and disputes over land use continue to hinder the GOI from moving more quickly on job creating public works programs.

¶10. (SBU) In terms of monetary policy, Bank Indonesia (BI) eased its overnight policy rate by 25 basis points on December 4, but ongoing pressure on the Indonesian rupiah (IDR) limits the central bank's ability to ease monetary policy at a rapid pace. Indonesia's currency continues to trade near the IDR/USD 11,000 level, up from 9,500 just three months ago, and rose above IDR/USD 13,000 during the month of November. Analysts expect pressure on the currency to continue given the risk of further capital flight amid global uncertainty and Indonesia's deteriorating balance of payments position. Indonesia's balance of payments turned negative during the third quarter of 2008, despite an improvement in the current account deficit. The negative balance resulted from a significant decline in the capital account balance. Net portfolio flows fell from \$4.3 billion in the second quarter to negative \$58 million in the third quarter. Analysts expect both the current account and the capital account to deteriorate further in the fourth quarter, as export growth and portfolio flows continue to decline, putting additional pressure on the IDR.

Banking Sector Vulnerabilities Rise

¶11. (SBU) The rapid increase in credit recent years provided considerable support for economic growth in Indonesia, but deteriorating credit quality and tighter liquidity conditions will temper banks' appetite to extend new loans and spur economic growth. Credit growth remained high through October 2008, with year-on-year growth reaching 37%, but signs of a slowdown are emerging. While recent official figures are unavailable, anecdotal information from the business community suggests a deceleration of credit growth in November. In addition, as the global crisis spreads to the real

sector, credit quality will likely deteriorate. While overall nonperforming loans in the banking sector remain low, at 3.9% as of October 2008, analysts expect an increase in nonperforming loans in the commodities and transportation sectors, as well as small and medium-sized enterprise (SMEs) and consumer segments. Loan concentrations in the mining, agriculture, and transportation sectors have increased in recent years; these sectors comprised 28 percent of total bank loans as of September 2008.

¶12. (SBU) Indonesian banks' cost of funds also continues to rise, putting additional upward pressure on lending rates. Deposit growth has improved but has not kept pace with credit growth and remains low, at a rate of 18% (yoy) in October 2008. Moreover, the lack of a blanket guarantee on deposits raises the risk of depositor flight to neighboring countries such as Singapore that have imposed a blanket deposit guarantee. At the same time, tighter liquidity conditions in the interbank market have increased the need for banks to attract additional deposits. Interbank lending rates remain roughly 100 basis points above the level recorded six months ago, as concerns about counterparty credit risk among banks persist, particularly in the wake of the failure of Bank Century. Deposit rates at some banking institutions have exceeded 13% in recent months, up from 9-10% in July and August. As a result, lending

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rates have risen to close to 18% and are unlikely to fall until confidence and liquidity in the interbank market returns.

Government Approval Ratings Unaffected, Yet

¶13. (SBU) Approval ratings for President Susilo Bambang Yudhoyono's administration have increased in recent months, largely in line with the easing of price pressures on average Indonesian households (ref D). As the impact of the global financial crisis spreads, these ratings trends may begin to weaken. The outlook for job creation and the cost of living have been significant drivers of confidence in the government in recent years, according to researchers at Danareksa. While lower global commodity prices and slower inflation will continue to boost purchasing power among the poor, the anticipated acceleration in job losses and decline in nominal wages could significantly dilute the impact of lower inflation. Spending associated with the 2009 election cycle and pro-poor government programs should help alleviate the immediate spending needs of Indonesian families. Yet the GOI's ability to create a significant number of long-term jobs and spur economic activity in the near term remains questionable.

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